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Minutes of Executive Board Meeting 85/103

10:00 a.m., July 3, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	K. Yao, Temporary
C. H. Dallara	
	L. Hubloue, Temporary
B. de Maulde	
M. Finaish	
	H. Kobayashi, Temporary
G. Grosche	
J. E. Ismael	
	L. Leonard
	J. R. N. Almeida, Temporary
H. Lundstrom	
E. I. M. Mtei	A. Abdallah
	M. A. Weitz, Temporary
	S. Geadah, Temporary
	J. E. Rodríguez, Temporary
J. J. Polak	
	A. J. Tregilgas, Temporary
	H. Alaoui-Abdallaoui, Temporary
	A. S. Jayawardena
	T. A. Clark
	L. Tornetta, Temporary
	Yang W., Temporary

J. W. Lang, Jr., Acting Secretary
R. S. Laurent, Assistant

Also Present

IBRD: F. Agueh, Eastern and Southern Africa Regional Office. African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; N. Abu-zobaa, J. Kakoza, S. N. Kimaro, M. C. Niebling, R. H. Nord, R. T. Stillson. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; A. K. Mitchell. Fiscal Affairs Department: J. C. Tavares. Legal Department: J. M. Ogoola. Bureau of Statistics: E. W. Saunders. Advisors to Executive Directors: E. A. Ajayi, D. Hammann, G. W. K. Pickering. Assistants to Executive Directors: C. Flamant, R. Fox, A. K. Juusela, J. A. K. Munthali, A. Mustafa, A. A. Scholten, E. L. Walker.

1. MOZAMBIQUE - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Mozambique (SM/85/158, 6/3/85; Sup. 1, 6/28/85; and Sup. 1, Cor. 1, 6/28/85). They also had before them a report on recent economic developments in Mozambique (SM/85/169, 6/14/85).

The staff representative from the African Department said that information recently received from the Mozambican authorities indicated that from 1980 to 1984 the decline in the global social product (GSP), and particularly in agricultural and industrial output, had been more pronounced than stated in the staff report. However, the revised data did not alter the overall interpretation of recent economic developments or the report on the consultation discussions.

Mr. Mtei made the following statement:

> Today's discussion on the 1985 Article IV consultation is the first opportunity for Executive Directors to review recent economic developments in Mozambique since it acceded to the Fund's Articles of Agreement in September of last year. The consultation discussions between the staff and the authorities took place against the background of a deteriorating economic and financial situation that is partly rooted in the country's history, dating as far back as 1964, when the ruling party the Mozambique Liberation Front (FRELIMO), launched its war of liberation that led to independence in 1975.
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> During most of the colonial period, a number of public and social amenities, including health and education, had been left relatively undeveloped, so that the illiteracy rate, for example, was estimated at about 93 percent at the time of independence. Portuguese expatriates and settlers provided the bulk of the manpower requirements in virtually all sectors of the economy. The development of the physical infrastructure was designed mainly to serve the hinterland, which is made up of the land-locked countries of Swaziland, Zimbabwe, Zambia, and Malawi, as well as the Transvaal province of the Republic of South Africa. The culmination of the protracted war into political independence left the country virtually starved of skilled manpower. Farming and manufacturing enterprises were abandoned and had to be taken over and operated by the new and relatively inexperienced public bureaucracy. At about the same time, the implementation of UN sanctions against the then Rhodesia, together with the subsequent deliberate action by South Africa to divert its import and export traffic to its domestic seaports, denied Mozambique some of its principal sources of foreign exchange. Furthermore, the restrictions that were being placed on Mozambican workers in South Africa considerably reduced workers' remittances from that country.

The current situation characterized by declining output, widening budgetary deficits, and a deteriorating external payments position can be traced to a large extent to the structural rigidities imposed by these historical factors. This has been accentuated since 1981 by the severe and prolonged drought that has affected most of southern Africa. In addition, a state of war prevailing in the last 20 years has rendered economic management difficult. In recent years, the intensification of banditry organized by political malcontents, who have been aided by outside forces, has exacerbated this situation. Despite the signing of the Nkomati Accord last year between Mozambique and the Republic of South Africa, which was designed, in part, to eliminate external assistance to these bandits, insurgent activities aimed particularly at disrupting economic infrastructure and installations have not ceased. As a consequence, future prospects, though basically promising, remain uncertain. Thus, my authorities would like to emphasize the conclusion reached by the staff that "an improvement in the security situation is necessary if corrective measures are to result in a recovery in economic activities and return to broad financial stability."

The interplay of these adverse exogenous factors strengthened the determination of the authorities to introduce corrective measures. This has meant that certain domestic economic policies had to be reviewed and this was enunciated at the Fourth Congress of FRELIMO held in April 1983. It is in this context that discussions are now well under way with the World Bank for an Emergency Rehabilitation Credit amounting to $45 million. Furthermore, the authorities are also hoping to put together a comprehensive set of adjustment measures for which they intend to seek Fund support. It is in this connection that the concern of the Mozambican authorities about the paucity of statistical data becomes relevant, a factor which, to a large extent, explains some of the shortcomings of recent policy action. To overcome the problem, they have asked the Fund for technical assistance to help in the construction of a reliable statistical base that will permit meaningful assessment of the situation as well as monitoring of economic developments.

The measures that the authorities are implementing are mainly aimed at stimulating agraricultural and industrial production by the introduction of a certain measure of liberalization and decentralization in the conduct of wages and pricing policy. To this end, the Government of the People's Republic of Mozambique announced several measures that provided state enterprises and provincial authorities with greater autonomy, implying that the authorities are to take into account local demand and supply conditions in determining the level of prices in various regions of the country. Action has also been taken to liberalize the marketing and distribution of agricultural products, while the prices of a number of commodities are being freed. At the same time, the authorities have announced substantial producer and consumer price increases, in some cases by as much as 158 percent, with a view to stimulating the private sector and attracting foreign investment. In agriculture the emphasis is now being placed on smallholder producers.

Fiscal operations have in recent years benefited from frequent revenue measures. Accordingly, government revenue has remained strong, with a peak of 29.9 percent of GDP in 1982. In the event, the recurrent budget has steadily produced savings that have been used to finance part of the investment budget. However, the recurrent budget weakened in 1984 and is expected to show another deficit in the current year, mainly on account of the decline in revenue reflecting the downswing in economic activity. As a proportion of GDP, total revenue is estimated to fall to 25.5 percent in 1985, with pronounced declines expected in respect of taxes on income and profits as well as on goods and services. This decline in government revenue has come at a time when expenditure is expected to rise to 42 percent of GDP in 1985 from 39.9 percent in 1984. The high expenditure reflects, among other things, the need to strengthen the security situation in order to combat the banditry referred to above. Expenditure on defense has also been at the expense of investment expenditure, which has fallen from its peak of 22.1 percent of GDP in 1983 to 12.4 percent in 1984 and 12.2 percent in 1985. The primary purpose was to bring total spending in line with available resources.

The public sector enterprises have been worrisome to the authorities as losses have mounted in recent years. The precarious position of a number of these enterprises can also be traced back to their abandonment by their original Portuguese owners and workers, the paucity of skilled and managerial manpower, a lack of spare parts, and the general decline of economic activity. As the losses have been financed principally through credit extended by the banking system, the authorities are taking action to halt further deterioration. To this end, the financing of the state enterprises' planned deficit in 1985 will be assumed by the state general budget. Meanwhile, a flexible pricing policy as well as the introduction of autonomy should help to strengthen their financial positions. Furthermore, to improve management, the People's Development Bank has been organizing seminars for the managerial staff of farming enterprises. At the same time the Bank of Mozambique is currently exercising stricter screening of credit requests and placing greater emphasis on careful monitoring of disbursements and repayments.

Monetary and credit policies have reflected public sector operations, accommodating, according to the Plan, the credit needs of the Government and state corporations. The Mozambican authorities hold the view that the banking system should be allowed to play its role in the implementation of the annual plan as agreed by the National Planning Commission. Thus, the Bank of Mozambique takes this into account in setting the credit targets and preparing the foreign exchange budget. However, the posture of current policy is to exercise and restrict the expansion of credit while endeavoring to mobilize financial saving, in part through the expansion of the banking network.

The balance of payments position has come under considerable pressure in recent years as exports declined markedly at a time when import demand expanded and receipts from transit traffic and workers' remittances dried up. The net position on the service account has remained negative since 1983. Despite a steady flow of official transfers, financing of the overall deficit has been met through external borrowing and accumulation of arrears. As a consequence, debt service payments have risen sharply in the past few years. The burden of these payments was eased somewhat in 1984 by rescheduling agreements concluded under the Paris Club. The authorities have expressed their intention to seek further debt relief. Nevertheless, they recognize and would like to emphasize that, apart from any relief measures, the economy needs substantial foreign assistance on highly concessional terms if a durable recovery program is to be successfully implemented.

Finally, on exchange rate policy, the authorities have indicated that studies are being undertaken in parallel with others on pricing and investment, designed to promote stable financial conditions. These studies should provide the basis for implementing appropriate action.

Mr. de Maulde commented that a number of the causes of Mozambique's present plight were beyond the authorities' control, but domestic policies had compounded the problems; to reverse the deterioration of the economy, action was urgently required. Agricultural production as well as industrial output had been declining steadily during the past few years, with a corresponding reduction in real wages and living standards for most Mozambicans. The budget deficit could reach 19 percent of GDP in 1985, with negative public savings representing 7 percent of GDP. The banking system was illiquid, with nonperforming loans amounting to 40 percent of the Bank of Mozambique's portfolio, and the money supply was expanding rapidly. Furthermore, revenues from exports and services had dwindled, while debt service payments had swelled: in 1984, before debt relief, Mozambique's debt service had reached 243 percent of its exports of goods and services. As a result, external arrears had accumulated, and imports had been constrained to such a point that shortages of raw materials, spare parts, and consumer goods had become widespread. In turn, such shortages contributed to reducing both the productive capacity of the country and the incentive for rural producers to harvest and market their crops. Thus, the economy was caught in a classic downward spiral.

A great many of Mozambique's present difficulties could be traced back to conditions prevailing at the time of independence in 1975, Mr. de Maulde acknowledged. The massive exodus of settlers and trained workers had been aggravated by the scanty education and training of the rest of the population, especially for high managerial and technical positions. Moreover, Mozambique's difficulties in its relationship with South Africa had resulted in less revenue from railway transport and less hiring of Mozambican miners. During the past few years, the country had also suffered a series of natural climatic disasters, with alternating floods and drought. Finally, the hope that the Nkomati agreement would lead to a downturn in guerilla activity had not been borne out, and security in the country had continued to deteriorate.

One of the authorities' inappropriate domestic policies had been the priority given until recently to the development of mechanized agriculture on state farms, established on large plantations of former settlers, Mr. de Maulde said. All over the world, state-owned and state-managed agriculture functioned poorly. Furthermore, owing to the limited amount of resources that could be channeled to agriculture, the priority given to large state farms had been detrimental to the development of smallholder production, especially as the authorities had neglected to set remunerative producer prices. He was encouraged that since the fourth congress of FRELIMO in 1983, official policies had changed: the authorities had become aware of the need to give priority to smallholder production and to rely more on price mechanisms. SM/85/158, Supplement 1 reinforced the impression that economic policies were moving in the right direction. However, the efforts made so far had brought about only mixed results, particularly for the marketing of agricultural produce, because of the shortage of consumer goods in the countryside.

The authorities needed to implement more comprehensive adjustment policies to lay the groundwork for a resumption of economic growth in the medium term, Mr. de Maulde suggested. Given the paucity of available statistics, the provision of technical assistance to establish a reliable database was a precondition to the elaboration of a coherent program, which might be supported by the Fund. He therefore welcomed the authorities' recent request for Fund technical assistance and the forthcoming staff visit to Maputo to identify the country's specific needs. If requested, his country would provide supplementary technical assistance, in close cooperation with the Fund.

For several years, in view of its large external imbalance, Mozambique would need both debt relief on generous terms and additional financing on conditions that should be as concessional as possible, Mr. de Maulde remarked. The adoption in the near future of some strong measures aimed at tackling the major disequilibria would transmit the correct signal to creditor countries. The most important of such measures would be a substantial exchange rate adjustment, which was indispensable to reverse the present backward trend toward a subsistence economy, where barter replaced monetary transactions.

He looked forward to close cooperation between the World Bank and the Fund on Mozambique, Mr. de Maulde concluded. Indeed, the Executive Board of the World Bank had approved a rehabilitation credit of $45 million. The country's difficulties were structural and needed to be addressed by long-term development assistance, but the Fund could help the authorities to put in place the macroeconomic framework required for supply-oriented policies to be effective. Technical assistance from the Fund should help the authorities to formulate and implement sweeping changes in their economic and financial policies.

Mr. Almeida said that his chair was particularly happy to give the warmest welcome to Mozambique in its first Article IV consultation since it had become a Fund member in September 1984. Mozambique was particularly close to one of the countries in his constituency, Brazil; it was the sixth Portuguese-language country to join the Fund.

The authorities were to be congratulated for having announced a series of measures designed to introduce greater flexibility in prices and wages and to provide public enterprises with more autonomy, particularly in decisions concerning imports and exports, Mr. Almeida continued. As the experience of many countries had shown, heightening the importance of market-related forces could significantly improve productivity in a socialist economy. The emphasis placed by the authorities on expenditure on health and education, areas in which substantial advances had already been made, was appropriate. He supported the authorities' request for technical assistance in devising economic policies and improving the statistical base, both of them urgent requirements. In addition, the authorities were considering the possibility of relying solely on budgetary expenditure to meet the losses of public enterprises, and they planned to terminate the access of such enterprises to the Bank of Mozambique; those two policy changes would represent key steps toward better management of the economy.

During the past five years, Mr. Almeida noted, exports and receipts from services had declined while the debt service had increased. Imports in 1984 had been at only two thirds of the 1980 figure, as the country had tried to balance its financial position. Despite the official debt rescheduling with OECD countries in 1984 and an increase in official transfers, the country's external position was likely to remain precarious at least until 1988. The international community ought to recognize the hindrances to Mozambique's efforts toward stabilization and be prepared to approve assistance on concessional terms. Finally, every effort should be made to obtain enough data to include a page on Mozambique in International Financial Statistics (IFS).

Mr. Polak said that it was crucial for the authorities to reverse the steady deterioration in Mozambique's economic performance since independence. Floods and droughts, the large-scale departure of trained manpower, and security problems had contributed to the deterioration, but even in more favorable circumstances, the country would be difficult to administer owing to the geographic structure of its transportation network and the location of the capital in the extreme south. Although the mass departure of Portuguese workers might have made state operation of factories and estates appear to be a natural solution in the short run, the Mozambican authorities had gone beyond that stage and introduced a full-fledged centrally planned economy. As a general policy, the Fund accepted any country's own approach to economic management, but Mozambique lacked the prerequisites for central planning; the authorities should rely more on market forces and price mechanisms in the allocation of resources. Furthermore, they ought to consider dismantling a large part of their central planning apparatus.

In agriculture, transportation, energy, and fishing, Mozambique had great potential to increase production, Mr. Polak noted. In some sectors, particularly transportation, an improvement in security would be of key importance. However, even on that front, improved domestic policies could make a significant difference.

The deterioration of the economy was most sharply reflected in the external sector, Mr. Polak observed. From 1980 to 1984, the value of the three major exports--cashews, tea, and sugar--had declined by 75 percent. During the same period, Mozambique's gold stock had fallen by 90 percent, while the external debt had risen from 150 percent of exports of goods and services to 1,140 percent. Notwithstanding rescheduling by the Paris Club, external arrears had increased to $545 million by end-1984, or 258 percent of Mozambique's exports of goods and services. The authorities had a great need for bilateral aid and an equally great need for strong Fund-Bank collaboration in helping them to overcome economic shortcomings; their request for technical assistance from the Fund in constructing a reliable statistical base would make possible a monitoring of economic developments, a precondition for the granting of Fund support to Mozambique. The Fund should respond to the request with rapidity and generosity. Finally, the authorities should adopt as soon as possible a comprehensive program along the lines advocated by the staff.

Mr. Clark commented that the uniqueness of Mozambique's position lay not only in the seriousness of the problems that it faced but in the extent to which the infrastructure for tackling those problems had either been eroded or, perhaps in some instances, had never existed. In collaboration with the World Bank, the Fund should play a central role in reversing Mozambique's recent history of economic decline. It would be a long and difficult task, but a start had been made with the recent approval of an IDA credit.

External developments had certainly played a large part in the decline in production and exports and the emergence of large external and internal imbalances, Mr. Clark continued, but the authorities' own policies had also contributed. As a result, substantial adjustment was needed on almost all fronts. However, at least for the time being, there was neither the statistical base nor the institutional framework to implement an upper-tranche Fund program along traditional lines. Moreover, with

Mozambique's external debt already larger than GNP, and with the debt service ratio projected to remain extremely high, sources other than the Fund would have to be the main suppliers of financial assistance. The Fund's role at the present stage should be primarily to provide technical assistance, particularly in building up the statistical and institutional framework that would be a prerequisite for any adjustment program, and in helping the authorities to formulate such a program. The World Bank would have to play a major role in parallel with the Fund, and the two institutions would need to collaborate closely. In turn, their joint involvement should help to give donors the needed reassurance that the Mozambican authorities were serious in their adjustment efforts and should encourage direct investment. They should implement additional policies, along the lines indicated by the staff, designed to attract that investment.

As the authorities of a centrally planned economy would not find it easy to move quickly toward decentralization and greater reliance on market mechanisms, Mr. Clark considered, the first steps in that direction were particularly welcome. One priority at present should be to strengthen the external sector, a task that would involve a major realignment of the official and parallel exchange rates for the metical. Even assuming that the authorities were correct in regarding Mozambique's trade as rather price inelastic, there would nevertheless be a case for a devaluation to encourage a shift of trade back into official channels. Was that inelasticity thought to arise mainly from the supply side or from the demand side? In parallel with action on the exchange rate, the authorities should encourage further price liberalization both in agriculture--the main private sector activity--and in industry, which was mainly within the public sector. The latter would have the additional attraction of reducing the deficit of public enterprises and hence their recourse to the banking system, and it would also tend to slow the growth of domestic credit and money. Improvements in the provision of data on public enterprises should be a top priority in any technical assistance effort by the Fund. Meanwhile, greater efforts were needed to improve monetary control, clearly inadequate at present. The authorities should also consider an upward adjustment of interest rates to stimulate the mobilization of domestic savings. In conclusion, a full return to economic and financial stability could probably not occur until security improved, but the economic situation had become so serious that urgent action in all the fields that he had mentioned was needed promptly.

Mr. Tornetta observed that Mozambique's difficult economic situation called for a prolonged readjustment effort through a consistent set of tight fiscal and monetary policies, accompanied by exchange rate adjustment and reforms in the pricing system. Recent changes in that system, as described in the supplement to the staff report, constituted a step in the right direction to introduce greater price flexibility. Determined action was needed in many other areas as well, and the authorities should begin promptly to implement corrective measures, a task in which Fund assistance and support could be essential.

Mozambique's balance of payments position appeared particularly difficult, with external debt equal to 119 percent of GDP, a debt service ratio of 170 percent after debt relief, and external payments arrears at six times the country's export earnings. During the past two years, exports of goods had fallen by two thirds in dollar terms, mainly owing to sharp drops in the volume of exportable agricultural goods. Therefore, the authorities should give priority to stimulating agricultural output by raising producer prices and providing incentives to workers in the state farms that produced a large share of export crops. For example, adequate incentives might be given if a state farm's production above certain levels were distributed to workers on the farm. In allotting foreign exchange, the authorities could also give greater priority to purchases of seeds and fertilizers. A depreciation of the exchange rate would be useful in strengthening the external position, provided that the effects were passed on to producer prices. Would such a pass-through occur under the current pricing system and distribution channels?

In 1985, Mozambique's budget deficit was projected to increase by 5 percentage points to 19 percent of GDP, or 25 percent of GDP if financial losses of public enterprises were included in the budget, Mr. Tornetta said. In addition, the deficit on current operations was projected to widen, while public investment was projected to decline. However, the authorities seemed reluctant to take the necessary corrective measures to reduce the deficit, despite the critical economic situation. Prompt action was required.

There were indications that liquidity might be excessive in Mozambique and that inflationary pressures were building up, Mr. Tornetta considered. Velocity had decreased sharply, and the ratio of broad money to GDP had risen from 44 percent in 1980 to 95 percent in 1984. Prices in the parallel market had risen rapidly during the past few years, probably as a consequence of insufficient supplies of goods and high liquidity in the economy. Monetary policy had been too accommodating. Tighter monetary policies were required and could be better implemented in a different institutional setting. For instance, central banking functions should be separated from commercial banking so that the authorities could better control credit expansion and liquidity creation. As part of the change, the Bank of Mozambique would have to acquire greater independence and should not automatically finance fiscal deficits or losses incurred by public enterprises, nor should it provide liquidity to the banking system above certain limits.

The Mozambican authorities intended to seek Fund support, Mr. Tornetta concluded. The availability of timely, reliable statistical data was a prerequisite for the negotiation of a program with the Fund, and he hoped that the authorities would be able to overcome such difficulties with the help of technical assistance from the Fund.

Mr. Grosche stated that Mozambique, richly endowed with natural resources, was faced with large internal and external imbalances. Real income had been shrinking rapidly, a large number of deficient public enterprises were using up national savings, and widespread price controls had led to sizable distortions; consequently, the economy was confronted with a large resource gap and a huge debt service burden, further compounded by difficult security problems afflicting transportation in particular. For example, since October 1983, the Cahora Bassa hydroelectric complex had not exported any electricity to South Africa because the power lines had been cut. Although the difficult political situation should not be minimized, Mozambique's present difficulties were being exacerbated by ill-conceived policies, which would have to be reversed promptly.

The projected increase in the state budget deficit and the rising share in GDP of current expenditures, which exerted a sizable negative effect on overall consumption and investment, were both causes for concern, Mr. Grosche remarked. Nationalization of enterprises had clearly been a failure. Agricultural production had fallen, and industrial production was only slightly more than half of what it had been three years previously. The authorities would have to make a determined effort, especially in those areas, to reduce the huge resource gap to a sustainable level.

Given the present institutional arrangements for monetary policy and the existence of widespread price controls, the adequacy of interest rates and the general conduct of monetary policy were indeed difficult to evaluate, Mr. Grosche considered. It was safe to say that the expansion of monetary aggregates had been too high in the past and that the authorities needed to promote a more flexible means of determining interest rates. They should not merely reorient the conduct of monetary policy but also thoroughly reconsider the entire financial system. There was an urgent need to design a more efficient banking system and separate commercial bank activities from those of the Bank of Mozambique.

While agreeing that the present balance of payments position was unsustainable, the Mozambican authorities were reluctant to correct the unrealistic exchange rate promptly and to liberalize the restrictive system of trade and payments for current international transactions, Mr. Grosche noted. Restrictions offered no lasting solution to external problems. Ultimately, it became imperative to reduce domestic absorption relative to output and to diminish external imbalances: under the needed comprehensive approach, the authorities should stress structural reform, effective demand management policies, and an exchange rate policy geared to balance of payments requirements. Structural reforms would be vital to bringing current production nearer to its much larger potential and must encompass all sectors of the economy--public enterprises, banks, prices, the exchange rate, and import restrictions--or the rehabilitation of the economy would prove unattainable. If implemented with vigor and determination in the context of much more restrictive financial policies, such reforms should improve the efficiency of Mozambique's economy and would also have a positive impact on creditors and aid donors. The first steps already taken on prices seemed to indicate that the authorities were envisaging other steps in the right direction. Finally, they should urgently improve the quantity and quality of statistical data. He supported the request for technical assistance from the Fund.

Mr. Dallara stated that he welcomed the opportunity to participate in Mozambique's first Article IV consultation with the Fund, through which the Fund provided Mozambique with technical expertise and policy guidance on areas for economic policy action. He stressed the importance of collaboration between the Fund and the World Bank on Mozambique. He supported the leading role taken by the World Bank through its economic and sector work in recommending actions that the authorities should take to create a sounder climate for economic development. Indeed, the Bank would continue to pursue the dialogue in the context of a second rehabilitation program where broader policy measures would be discussed. The Fund's suggestions for action should supplement and reinforce the efforts of the World Bank; together, the two institutions could provide a basis for action needed by Mozambique to restore its economic health.

Although difficult to assess owing to the inadequacy of statistical data, the state of Mozambique's economy appeared critical, Mr. Dallara said. External factors, including natural disasters and security difficulties, had naturally played a major role in the deterioration during the past decade, but government policies had made a contribution, particularly by dampening private sector activity. Market forces had played virtually no role in the allocation of resources; price controls, exchange restrictions, and supply problems had fed the development of thriving illegal markets. The unsustainable fiscal and payments deficits had resulted from the unsustainable burden of the Government's pricing policies and other inefficient policies related to state enterprises, the cost of defense and security, and the loss of export earnings from farm crops. Serious debt problems had begun to surface only in recent years, in part owing to the use of previously unavailable foreign reserves. As external arrears had accumulated because of a lack of foreign exchange, the crisis in the external sector reflecting the domestic imbalances had grown. Neither the internal nor the external imbalance was sustainable.

Nevertheless, the potential for economic recovery and development in Mozambique did exist, given internal stability and the adoption of appropriate measures for generating donor support, Mr. Dallara noted. Such support would be realized only if the authorities were determined to make strong efforts to agree upon and implement the needed economic reforms. He hoped that the Fund's provision of technical assistance to identify needed reforms would play an important role. Obviously, both the authorities and the Fund would have to make an effort to create the statistical base necessary for economic assessments of Mozambique. The adoption of economic reforms in several key areas along the lines proposed by the Fund would send a signal to Mozambique's creditors that the authorities were prepared to tackle the serious difficulties that existed and would also serve as a catalyst for financial support from the donor community.

The recent measures taken by the authorities in adapting the pricing and wage policies were in the right direction, Mr. Dallara commented. Guided by an overall policy of greater emphasis on market forces, the authorities should continue their efforts to make the pricing system more market oriented. They should also undertake stronger initiatives to promote the private agricultural sector, which had proved more productive than both state and cooperative farms, through pricing as well as marketing and other incentives. In addition, they should liberalize the restrictive trade and payments regime, substantially depreciate the metical, move state enterprises toward greater privatization, which could be supported by the IBRD, and implement strong monetary and credit policies in conjunction with changes in the policies of state enterprises. The authorities should consider immediate action in those areas, as any delays could only exacerbate an already unsustainable situation. Particularly urgent was action on the exchange rate and other areas of pricing. Only by demonstrating a strong commitment to economic adjustment could the authorities expect to begin to generate immediate donor support, which would be critical for a viable adjustment effort. Finally, he supported the proposed decision and hoped that the authorities could make progress in reducing restrictions.

Mr. Yao remarked that the deterioration of the Mozambican economy that had begun during the war of liberation had worsened in recent years: economic activity had declined, the budget deficit had widened, and the current account deficit had become unsustainable. As indicated by the authorities, those unfavorable developments were largely a reflection of a shortage of skilled labor, a continuing state of war, and a recurrence of natural calamities.

Mainly as a result of protracted guerilla activities and partly as a result of the drought affecting the region, both agricultural and industrial production had stagnated in 1981, then fallen sharply in 1982 and 1983, Mr. Yao continued. Not only had those developments weakened the productive base, but they had also made the country dependent upon imports for a large share of domestic consumption. As the authorities had said, a sustained upturn of economic activity in Mozambique was predicated upon an improvement in the security situation. Nevertheless, he hoped that production would be stimulated by the authorities' willingness to allow the price mechanism and market forces to play some role in resource allocation, to decentralize the decision-making process, and to expand the role of private commercial farms.

Owing mainly to increasing outlays on security, the budget deficit before grants had remained relatively large between 1980 and 1984 at an average of 11 percent of GDP, Mr. Yao observed. Indeed, expenditure on defense and security had steadily increased from 31.2 percent of current expenditure in 1980 to 43.8 percent in 1984. Undoubtedly, an improvement in security would favorably affect total spending and thus the fiscal deficit. The increase in the consumption tax at a time of limited supply bore witness to the authorities' courage in attempting to gather more revenue; measures to strengthen tax administration were also steps in the right direction. However, the projected deterioration in the budgetary position for 1985 was worrisome. Specifically, the expected decline in revenue underscored the need for growth-oriented policies that would widen the tax base.

A pronounced deterioration in the productive base of Mozambique, together with an expansionary credit policy, had contributed to the emergence of an unsustainably large deficit on current account averaging 22 percent of GDP during 1980-84, Mr. Yao concluded. The authorities had financed the deficit by external borrowing and by accumulating payments arrears. They needed to address those developments in the external sector in order to restore the financial viability of the economy. In conclusion, the rehabilitation of the productive base depended upon an improvement in security, but the authorities needed to support their development efforts with adequate macroeconomic policies. They also needed generous assistance from bilateral and multilateral sources.

Mr. Jayawardena commented that an evaluation of the real situation in Mozambique was made extremely difficult by the paucity of reliable data, but the problems facing the country were daunting. However, their very seriousness might make them easier to solve. When an economy as tightly regulated as that of Mozambique became so disequilibrated, it was not unusual for a parallel market to pervade the entire economy. Such a market tended to demonstrate accurate economic relationships, and citizens tended to react in terms of the dictates of that market, rendering government intervention in regulating prices or allocating credit more or less irrelevant. Thus, a parallel market helped national authorities to determine the necessary adjustment measures. It should allay any fears that the removal of regulatory measures would impose excessive hardships on people, who were already engaging in transactions in a market where the adjustment process could permeate the economy much more effectively. Hence, Mozambique's situation seemed difficult but hopeful.

No doubt the security situation made the option of implementing strong measures more difficult and might slow the pace of adjustment, Mr. Jayawardena stated. However, the authorities ought to react to the actual economic situation rather than to an imaginary one that appeared to be reality when viewed through the regulatory system. They had no alternative to pursuing adjustment. In general, if national authorities did not react to reality, their economy would eventually adjust but at greater cost or with greater hardship, irrespective of whether the economy was market oriented or centrally planned.

One decade previously, Mr. Jayawardena recalled, the Mozambican authorities had faced extraordinary difficulties upon independence, which had been compounded by the fact that the colonial economy of the country had evolved as totally dependent on neighboring states. A coordinated development strategy with neighboring countries, designed to restructure the economy with substantial resource transfers from abroad, would have been the best strategy, but hostilities in the region had precluded that option. Hence, the authorities' main concern had been to prevent a complete collapse of the economy by taking over abandoned enterprises and instituting central planning. However laudable their objectives, they had not possessed at the time, and still did not possess, the prerequisites for state management and centralized planning such as an adequate database and a plentiful supply of skilled managers. In addition, unfavorable climatic developments had contributed to a continuous decline of the economy and an unsustainable external position.

He would support a strong adjustment package backed by substantial bilateral donor support and also by the Fund and the World Bank, Mr. Jayawardena continued. The authorities should accord the highest priority to restoring incentives by removing price distortions, a shift that would naturally entail a more flexible exchange rate policy and a liberalization of trade and domestic markets. Through appropriate income and support schemes, subsidies might be better channeled to the most indigent. Given Mozambique's extensive borders, with six neighboring countries and a long tradition of cross-border transit, it was difficult to imagine how any other set of policies could have worked. In fact, during the transition, the authorities might be pleasantly surprised at the potential of even the least developed economies to respond to market stimuli. However, given the low income per capita and the virtual absence of infrastructure, donor support would be crucial to the success of a good adjustment program, a topic on which he welcomed recent initiatives by the World Bank. Technical advice regarding management and statistics would also be critical. He would support proposals for the Fund to provide assistance for structural adjustment or a demand management program in Mozambique. That the economy had not collapsed under the massive strains of recent times demonstrated the authorities' great resiliency, and Fund resources were most likely to be constructively used.

Mr. Finaish remarked that the case of Mozambique was a particularly difficult one, since economic and financial imbalances were large by any standard and widespread throughout the entire economy. As a result, real GDP had fallen substantially in recent years, and the prospects for the external sector and the balance of payments were particularly worrisome. Considerable pressure upon the external payments position in recent years had resulted in an extremely difficult external debt burden characterized by substantial arrears.

For some time to come, sustainable growth and balance of payments viability would remain difficult objectives to obtain, Mr. Finaish considered. Upon independence, Mozambique had inherited an illiteracy rate of 93 percent, a severe shortage of skilled manpower, abandoned enterprises, and transport infrastructure designed to serve neighboring countries; those major obstacles to development efforts had been aggravated by the allocation of substantial resources to cope with the security situation. In addition, a major loss of foreign exchange receipts had occurred owing to the diversion of transit trade by South Africa and the restrictions imposed by that country on Mozambican workers. A severe, prolonged drought had also paralyzed agricultural production in recent years.

Although in Mozambique's circumstances domestic resource mobilization and economic adjustment were not easy tasks to undertake, they were urgently needed, Mr. Finaish stated. It was therefore encouraging that the potential for growth and stability in Mozambique existed and that the authorities were considering designing a comprehensive set of adjustment measures to utilize that potential, as had been noted by Mr. Mtei in his opening statement. He supported the authorities' request for technical assistance from the Fund in statistics to overcome the related problem of a deficient database.

The staff representative from the African Department explained that with the right set of policies, including the correct exchange rate, output and exports would prove highly elastic. Although Mozambique would continue to be a price taker, the increase in output resulting from the application of such policies would more than offset any low prices prevailing on world markets. However, if the authorities raised producer prices without adjusting the exchange rate, large losses for the marketing agencies would result. Therefore, an adjustment in the exchange rate for the metical would be crucial to avoid any such losses.

Mr. Mtei observed that exogenous factors had been the main cause of most of Mozambique's difficulties. Until the security situation improved, the authorities would be unable to implement the domestic policies aimed at adjustment that had to be put in place despite the hardship that they might cause for the Mozambican people.

To be effective, any action on the exchange rate would have to be buttressed by other policy measures, Mr. Mtei remarked. Therefore, the authorities wished to have available a comprehensive study of all measures necessary before they took action on the exchange rate. As for the reference in the staff report to the effect of the overvaluation of the metical which had supposedly led to a reduction in railway traffic from South Africa, the authorities had pointed out that railway freight charges were paid in South African rand, so that the appreciation of the metical had had no effect upon such charges. The decision to divert traffic from Mozambique had been deliberately political and had begun in the 1970s, before the metical had begun to appreciate against the rand.

Mozambique's fiscal deficit was large mainly because of the security situation, Mr. Mtei observed. However, the authorities had also drastically curtailed public investment in order to conserve whatever funds might be available for tackling security difficulties. There had also been a reorganization to ensure that deficits of public enterprises were borne by the Bank of Mozambique rather than by the Government of Mozambique, a step that would facilitate monitoring and control besides improving general management.

Some rescheduling of the country's debt had taken place under the Paris Club, Mr. Mtei recalled; the authorities hoped that further rescheduling could take place later in the year. Rescheduling would be facilitated even more when the country had concluded an arrangement with the Fund. However, Mozambique would need substantial financial assistance from both bilateral and multilateral sources in the medium term if it were to undertake the rehabilitation of the economy in a meaningful manner, owing to the magnitude of the external imbalances.

The authorities were currently encouraging smallholder farming, Mr. Mtei noted, but private sector farming had also been an ingredient of the agricultural sector. Indeed, the formation of state farms had partly resulted from the abandonment of estates by Portuguese settlers and managers at the time of independence. Well aware that state farms were difficult to manage, the authorities had had no option but to take over the abandoned properties. Subsequently, they had chosen to establish centralized management of the economy; in any event, few private organizations existed in the country that could take over such farms.

He was gratified by the readiness of the Executive Board to facilitate Fund technical assistance for Mozambique, Mr. Mtei continued. He hoped that with such assistance Mozambique would be able to put together a comprehensive program that would help to resolve present difficulties.

The Acting Chairman made the following summing up:

> Executive Directors were in broad agreement with the general assessment and views expressed in the staff appraisal for the first Article IV consultation with Mozambique. They noted the extremely difficult internal and external circumstances that the authorities had had to deal with during the past five years, particularly the impact of prolonged and severe droughts and the deterioration of security conditions. While they shared the authorities' view that a cessation of the internal armed strife was an essential condition for a return to broad financial stability, they believed that fundamental corrective measures were required to arrest further economic and financial deterioration and to establish the preconditions for developing Mozambique's rich natural resource base. In this connection, Directors welcomed the initial steps taken by the authorities that would move the economy toward being market oriented. Directors noted that in order to permit an adequate assessment of the needed corrective measures, there was an urgent need to improve the collection and reporting of economic and financial statistics.
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> Directors welcomed recent efforts made by the authorities to boost producer prices and to liberalize consumer prices of some agricultural commodities, and urged that these efforts be continued in a systematic way to halt the decline in production and also to reduce smuggling and the activities of the parallel markets. Directors also encouraged the authorities to consider relying in the future more extensively on private sector farming, rather than on state farms.
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> Directors stressed the crucial importance of reducing the large unsustainable fiscal imbalances, including a large fiscal deficit brought about by the large increase in current expenditures. In this regard, Directors noted the detrimental impact of state enterprises on the budget, thus reinforcing the need to undertake urgently an overall rehabilitation of public enterprises.

While recognizing the difficulties in evaluating monetary policy, Directors expressed concern about the high rate of monetary growth and the inflationary implications of excess liquidity. They also expressed concern about the accumulation of nonperforming loans by the banking system. Thus, they encouraged the authorities to take critically needed structural measures--including increases in interest rates--to mobilize domestic savings through the banking system and channel them toward productive investments at home. Directors also suggested that the authorities consider a structural reform that would separate commercial banking activities from central banking activities, thus permitting greater independence on the part of the central bank.

Directors expressed their deep concern about the sharp deterioration of Mozambique's external situation. They believed that a substantial depreciation of the exchange rate and a progressive elimination of exchange and payments restrictions was needed to bring about improvements in this area. Directors felt that such a course would enable the authorities to give a signal for the start of early negotiations with creditors for debt rescheduling on the basis of a realistic and comprehensive set of adjustment measures. Such measures would also facilitate further inflows of concessional foreign capital. Directors emphasized the importance of close and continuing collaboration between the Fund and the World Bank in assisting Mozambique, and they stressed the important role that Fund technical assistance could play in assisting the Mozambican Government.

Given Mozambique's difficult economic and balance of payments situation, it is expected that the next Article IV consultation with Mozambique will take place on a 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Mozambique, in the light of the 1985 Article IV consultation with Mozambique conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Mozambique maintains restrictions on payments and transfers for current international transactions, including external payments arrears, and a multiple currency practice as described in SM/85/158. The Fund encourages the authorities to liberalize these restrictions as soon as possible, and to terminate the bilateral payments agreement that is maintained with a Fund member.

Decision No. 8018-(85/103), adopted
July 3, 1985

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/102 (7/1/85) and EBM/85/103 (7/3/85).

2. 1985 ANNUAL MEETING - EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters concerning representation expenses at the time of the 1985 Annual Meeting as set forth in EBAP/85/171 (6/28/85).

Adopted July 2, 1985

3. 1985 ANNUAL MEETING - EXECUTIVE BOARD - TRAVEL ARRANGEMENTS

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters concerning travel arrangements for the 1985 Annual Meeting as set forth in EBAP/85/172 (6/28/85).

Adopted July 2, 1985

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/173 (7/1/85) and travel by Advisors to Executive Directors as set forth in EBAP/85/169 (6/28/85) and EBAP/85/173 (7/1/85) is approved.

APPROVED: April 9, 1986

LEO VAN HOUTVEN
Secretary